CHAPTER 6

A Pro-Growth Agenda for the Global Economy

Many developing countries throughout the world have taken important steps in recent years to promote the growth of their economies. Their actions have lifted millions out of poverty, improved the health of their populations, and contributed to progress in addressing environmental challenges. Other countries, including some of the world's poorest, have had less success in achieving and sustaining strong economic growth. Developed and developing countries alike face the challenge of improving economic performance around the globe, so that more people can share in the benefits that come with growth. The United States stands ready to address that challenge.

This chapter lays out some key factors that have been found to promote and sustain faster economic growth. Although these factors are important in all countries, the chapter's primary focus will be on growth and development in low- and middle-income economies. Three broad principles—securing economic freedom, governing justly, and investing in people—underlie these key growth-promoting factors and provide the organizing structure for the discussion. Adoption of these principles creates an environment where market signals lead to better economic performance.

Economic freedom promotes growth by encouraging competition and entrepreneurship. Securing this freedom requires creating a stable domestic macroeconomic environment with low inflation, regulating appropriately, encouraging entrepreneurial initiative, and opening to the global economy. Governing justly means establishing the rule of law, controlling corruption, and guaranteeing political freedoms; all of these help develop trust in the accountability and reliability of the government, which in turn encourages entrepreneurship. Investing in people means devoting resources to enhancing the productive capacity and well-being of the general population, in particular through improvements in education and health. Countries that ignore this task will see their economic growth suffer, because people who are in poor health or poorly educated are less productive.

No one of these principles suffices to guarantee strong growth; all three are mutually reinforcing aspects of a pro-growth agenda. Actions by the United States, the broader international community, and the international financial institutions can help developing countries improve their economic performance. But creating the proper incentives for domestic growth ultimately depends on decisions by those countries' own citizens and governments.

The Administration has undertaken three important international economic policy initiatives that are consistent with these pro-growth principles. First, it has sought and obtained from the Congress authority for the President to negotiate and conclude trade liberalization agreements with other countries in a streamlined fashion; the agreements reached under Trade Promotion Authority will increase the integration of the world's economies, especially those of developing countries. Second, the Administration has launched the Millennium Challenge Account program, which will extend additional developmental aid to the world's poorest countries provided they have adopted pro-growth policies. Third, the Administration has called for reform of the multilateral development banks, including both the World Bank and the regional development banks, to increase their effectiveness in spurring economic growth through greater emphasis on measurable results and activities that increase productivity, including private sector development.

In August of last year, the Congress granted the President Trade Promotion Authority (TPA) through the Trade Act of 2002. This legislation authorizes the President to negotiate trade liberalization agreements with other countries and commits the Congress to a yes-or-no vote, without amendments, on any agreements reached under this authority. The President's enhanced ability to engage in international trade negotiations under TPA will help the United States conclude agreements that will increase competition, boost productivity, and promote growth in both the United States and its trading partners. TPA will enhance U.S. influence and effectiveness at the trade negotiating table and will bring economic benefits to American families, workers, farmers, and firms. Current U.S. proposals for trade liberalization of nonagricultural goods alone could save Americans about $18 billion a year in import taxes, resulting in $1,600 worth of benefits annually for an average family of four. This renewed negotiating authority will also promote prosperity in our trading partners, including developing countries. Indeed, those countries that are now the least integrated into the world economy—including many of the world's poorest—stand to gain the most in proportion to their current incomes from the increased openness that TPA makes more likely.

The Administration is already engaged in negotiating trade agreements in a variety of contexts, including the multilateral negotiations organized under the auspices of the World Trade Organization as well as regional negotiations, such as those toward a Free Trade Area of the Americas, and various bilateral free trade negotiations. All of these initiatives seek to promote economic growth by decreasing barriers to trade in goods and services and establishing effective procedures for settlement of international disputes involving trade. Moreover, the rules-based trade agreements that are the object of these negotiations will provide incentives for developing countries to improve their own domestic institutions to provide greater transparency, strengthen the rule of law, and improve the protection of property rights.

The second major Administration initiative, the Millennium Challenge Account (MCA), will provide grants in aid to those developing countries that qualify by fostering and maintaining an environment conducive to economic growth. Funding for the MCA will increase over 3 years to a total of $5 billion in 2006, an almost 50 percent increase over current U.S. bilateral development assistance. Recipients of MCA grants will be chosen by their demonstrated commitment to the three principles mentioned at the outset: securing economic freedom, governing justly, and investing in people. The specific MCA criteria associated with each of these principles are described in more detail later in this chapter.

The Administration's third pro-growth initiative involves reform of the multilateral development banks (MDBs). Meaningful reform of these institutions will raise economic growth and prosperity in poor countries around the world by encouraging the MDBs to focus on increasing productivity growth in those countries. The MDBs can do this by fostering innovation to support private sector development, insisting on measurable results as a condition for continued aid, and delivering an increased share of total assistance in the form of grants rather than loans.

The Administration believes that pursuing the pro-growth policies outlined in this chapter will help restore the flow of investment to low- and middle-income countries. This flow was interrupted by frequent and severe economic and financial crises in some of these countries during the 1990s. Net international private capital flows, which averaged more than $150 billion a year from 1992 to 1997, fell to less than $50 billion a year in 1998-2000. Restoring strong private investment flows into low- and middle-income countries will help create higher productivity jobs and raise living standards.

The chapter begins by laying out some basic facts about economic performance and social indicators in the developing world. It then discusses the three principles enunciated above and how they have been shown to lead to faster economic growth. Finally, the chapter discusses the Administration's three major initiatives and how they embody pro-growth principles.

The Importance of Growth

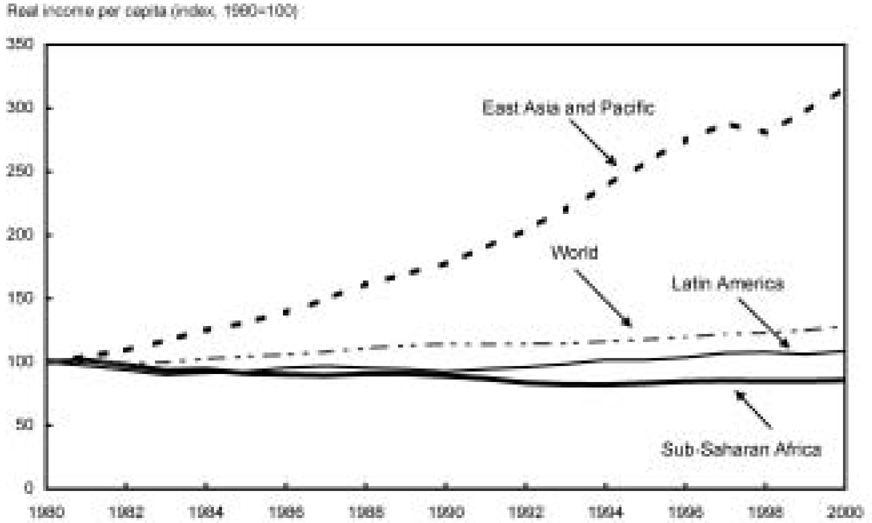
The term "economic growth" can be understood both in narrow, quantitative terms and in a broader, more qualitative sense. Economists often measure growth as the annual percentage change in a country's real gross domestic product (GDP) per capita, that is, the 1-year change in the country's income, adjusted for inflation and divided by the number of people residing in the country. By this definition, growth simply indicates how the income of the average resident of the country has changed from one year to the next. In qualitative terms, however, sustained strong growth over time means prosperity instead of poverty, job creation in place of economic stagnation, and children who are strong and healthy rather than malnourished and facing death from illness. Helping countries boost their economic growth, in other words, is not just a matter of statistics; it is about improving the lives of human beings.

The Global Growth Experience

Chart 6-1 illustrates the wide divergence in growth paths for several major world regions from 1980 to 2000 (all of the growth rates that follow are in terms of real GDP per capita). World income per capita grew at an annual rate of 1.3 percent, increasing a total of 28 percent over the period. Performance in the East Asia and Pacific region (East and Southeast Asia plus Australia, New Zealand, and the Pacific island nations) far exceeded this benchmark: average income per capita in these countries more than tripled, from $396 in 1980 to $1,252 in 2000, with growth of more than 6.2 percent a year. In contrast, incomes per capita in Latin America rose only from $3,548 in 1980 to $3,856 in 2000, which translates to an annual average growth rate of less than 0.5 percent. Average annual income per capita in the countries of Sub-Saharan Africa actually fell by 14 percent during the period, from $658 in 1980 to $564 in 2000, or by 0.8 percent a year. (Unless otherwise noted, all income levels in this chapter are reported in constant 1995 dollars.)

Measures of countries' adherence to the pro-growth principles introduced above, and described in more detail below, suggest possible reasons for this huge variation. One is the presence or absence of macroeconomic stability: inflation varied substantially among the three regions, in a pattern that mirrors their growth outcomes. Annual inflation in Latin America as a whole remained relatively high during the 1980s and 1990s, averaging about 25 percent. In contrast, inflation in the fast-growing East Asia and Pacific region averaged only about 12 percent during these two decades but fell sharply in many countries over the period. Inflation in slow-growing Sub-Saharan Africa also averaged only about 12 percent. However, unlike in East Asia and the Pacific, inflation in Sub-Saharan Africa rose over the period, from 10 percent in the 1980s to 16 percent in the 1990s.

Chart 6-1 **Regional Economic Performance**
Countries in East Asia and the Pacific grew more quickly than those in Latin America and Sub-Saharan Africa from 1980 to 2000.



Source: World Bank, *World Development Indicators*, 2002.

There were also important regional differences in the degree of countries' openness to the global economy. The ratio of total international trade in goods (imports plus exports) to GDP is a common measure of this openness. In East Asia and the Pacific this measure rose from 39 percent in 1980 to 66 percent in 2000; it rose more modestly in Latin America over that period, from 26 percent to 38 percent. Sub-Saharan African trade as a fraction of GDP rose only from 55 percent in 1980 to 57 percent in 2000. In short, the different regions' growth performances are mirrored in the changing role of trade in their economies.

Investment in people also varied considerably across regions. Only about half of all children in Sub-Saharan Africa complete primary school, according to surveys conducted from 1992 to 2000; the completion rate in East Asia and the Pacific was almost twice as high. Information for the period from 1995 to 1999 indicates that average child immunization rates for measles, a key indicator of health care for children, were 53 percent for Sub-Saharan Africa versus 85 percent for East Asia and the Pacific.

Pro-growth policies have yielded important success stories in individual countries as well, with a number of developing countries in Asia, Latin America, and Africa significantly outperforming their neighbors in achieving higher standards of living. The growth experiences of China and India, both of which have undertaken far-ranging economic reform in recent years, have been especially impressive. (Box 6-2 later in the chapter discusses China's reforms.) China's income per capita grew from $167 in 1980 to $824 in 2000, for an average annual growth rate of 8.7 percent. India's GDP per capita grew on average by 3.8 percent a year over the same period, from $226 in 1980 to $459 in 2000. Both countries were among the world's poorest at the start of the period. Their growth rates are even more noteworthy given that the average growth rate for this period for the poorest countries as a group (those with incomes per capita of less than $800 in 1980) was only 0.5 percent. Economic growth in China and India has helped reduce their combined poverty rate (the percentage of the population with incomes below $1 a day) from 62 percent in 1977-78 to 29 percent in 1997-98. (Incomes here are evaluated at purchasing power parity, that is, adjusted such that $1 purchases the same amount of goods and services in all countries.) The enormous size of the population in both China and India (21 and 16 percent of world population in 1998, respectively) means that economic progress in these two countries alone has contributed significantly to reducing global poverty.

Chile and Botswana are examples of countries in other regions that have also instituted pro-growth polices with impressive results. Chile has undertaken major tax reform, opened its economy to international trade and investment, privatized important sectors of the economy, and reintroduced democratic governance. Botswana has protected private property, discouraged corruption, invested heavily in education and health, and maintained sound fiscal and monetary policies. Neither country would seem to be particularly well situated geographically to benefit from an integrating global economy. Botswana is landlocked and is located in a region with some of the worst economic performance in the world; Chile is located thousands of miles from major markets in the United States, Europe, and Asia, and some of its larger neighbors have suffered recurrent economic crises. Yet Botswana and Chile recorded average annual per capita growth rates of 4.6 and 3.7 percent, respectively, from 1980 to 2000—far better than either the world average of 1.3 percent or the 1.9 percent average for middle-income countries (defined by the World Bank as those with incomes per capita between $755 and $9,266, in 2000 dollars). Part of the explanation for their impressive growth is the relatively stability of their macroeconomic environments: annual inflation during 1980-2000 averaged 15 percent in Chile and 11 percent in Botswana. Moreover, Chile's inflation rate fell dramatically over the period, from 29 percent to only 4 percent; the Latin American average for inflation, as noted above, was 26 percent over the same period.

Despite the successes of Chile and Botswana, there are numerous stories of countries that have experienced economic stagnation or even contraction. In 28 countries out of 134 for which consistent and complete data are available, annual average growth in GDP per capita ranged between 0 and 1 percent from 1980 to 2000. GDP per capita fell during that period for another 41 countries in the sample—in several cases by more than 30 percent over the period as a whole.

The most troubling data are those that show a number of the world's poorest countries becoming even poorer over the past two decades. For example, Sierra Leone (with annual income per capita of $293 in 1980), Zambia ($584), and Nicaragua ($671) experienced average annual per capita growth rates of –3.6, –2.1, and –1.9 percent, respectively, over 1980-2000. Real income per capita in Niger plunged 38 percent over the same period, to only $203. In countries such as these, life has become much more difficult for millions of people, many of whom were already living at the edge of destitution.

The growth experiences of these desperately poor countries reflect their failure to promote economic freedom, govern justly, and invest in their people. Macroeconomic instability has been a serious problem for most of these countries: in Nicaragua, annual inflation during the 1980s and 1990s averaged a staggering 1,453 percent; the figures for Zambia and Sierra Leone, at 53 percent and 47 percent, respectively, are modest only by comparison. Measures of openness have been scarcely any better. Sierra Leone's trade as a ratio to its GDP fell from 56 percent in 1980 to only 25 percent in 2000. Zambia's involvement in the global economy also declined: its trade was equivalent to 68 percent of its domestic economic activity in 1980 and fell to 54 percent in 2000.

The Benefits of Growth

Statistics on GDP per capita and its growth fail to capture the full human tragedy now playing out in the poorest countries. Already-poor countries experiencing stagnant, or even negative, growth have difficulty coping with the basic problems of human existence. Table 6-1 shows that, in 2000, the world's low-income countries suffered from higher rates of malnourishment, shorter life expectancies, and dramatically higher infant mortality rates than did countries with higher incomes. About one-quarter of the population of the low-income countries was undernourished, according to a sample taken over 1996-98, compared with only 11 percent of the population in the middle-income countries. In 2000, mortality among children under 5 years old reached 115 per 1,000 in the low-income countries, compared with only 7 per 1,000 in high-income countries. Life expectancy in low-income countries was 19 years shorter than in high-income countries (59 years versus 78 years), a difference that in part reflects the prevalence of epidemics like HIV/AIDS (Box 6-1).

The positive association between higher levels of income and improved social indicators highlights the importance of economic growth for improving the human condition. This relationship was demonstrated in a

TABLE 6-1.—*Income per Capita and Social Indicators*

Indicator	Low-income countries	Middle-income countries	High-income countries
Prevalence of undernourishment (percent of population)	24	11	([1])
Under-5 mortality rate (per 1,000 children)	115	39	7
Life expectancy at birth (years)	59	70	78
DPT immunization (percent of children under 12 months)[2]	57	90	89
Measles immunization (percent of children under 12 months)	57	89	92
Public expenditure on health (percent of GDP)	0.9	2.9	6.0
Public expenditure on education (percent of GDP)	3.4	4.5	5.6
Addendum: Number of countries in each income category	*63*	*92*	*52*

[1] Not available.
[2] Immunization for diphtheria, pertussis, and tetanus.

Note.—Income is defined as gross national income per capita in 2000: low income, $755 or less; middle income, $756-$9,265; high income, $9,266 or more.

Data are for 1996-1998 for undernourishment; 2000 for mortality rate and life expectancy; 1995-1999 for immunization; 1994-1999 for expenditure on health; and 1998 for expenditure on education.

Source: World Bank, *World Development Indicators,* 2002.

study of 58 developing countries from 1960 to 1985, which found that a 1 percent increase in income per capita is associated with a decline in infant mortality of as much as 0.4 percent. This estimate implies that a 1 percent increase in income per capita across the developing world could have averted 33,000 infant and 53,000 child deaths annually. Other broad measures of social outcomes reflect similar patterns. The fast-growing region of East Asia and the Pacific recorded a 45 percent decline in the rate of under-5 mortality over the period 1980-2000, compared with only a 13 percent decline in Sub-Saharan Africa. Undernourishment fell by 30 percent in East Asia and the Pacific, but rose by 3 percent in Sub-Saharan Africa, during the 1990s.

Economic growth does not just lead to higher average incomes for poor countries; it also offers hope for those at the margins of society. A study of 92 developing and developed countries over 1950-99 found that the incomes of the poor (defined as the poorest fifth of each country's population) rose one for one, on average, with national income per capita (Chart 6-2). This means that economic growth did not just benefit societies' richest but helped the poorest strata as well. Data show, moreover, that worldwide economic growth over the past 20 years has been accompanied by the lifting of 200 million people out of poverty (where the poor are defined as those with incomes of less than $1 a day, in 1985 dollars). Nonetheless, the economic benefits of growth have not reached to every corner of the world. The World

Box 6-1. Combating the HIV/AIDS Epidemic in Africa

The impact of the worldwide HIV/AIDS epidemic is perhaps most dramatic in Sub-Saharan Africa. By the end of 2002 an estimated 29.4 million Africans were HIV-positive, about 70 percent of the global total. In the previous year, 9 percent of all adults in Sub-Saharan Africa were living with HIV/AIDS, compared with 1.2 percent globally. AIDS is now the leading cause of death in the region. The epidemic has dramatically reduced life spans: estimates suggest that the region's average life expectancy of 47 years would now be 62 years if the epidemic had never occurred.

Although the greatest tragedy of AIDS is the misery and loss of life it inflicts, the disease has also brought severe economic consequences to a region already suffering from extremely low incomes per capita and often-negative growth rates. Estimates suggest that AIDS has cut annual economic growth in the region by 2 to 4 percentage points. South Africa, one of the region's most important economies, could suffer a drop in its economic growth by as much as 2.6 percentage points as a result of the disease.

The economic consequences arise from a number of sources. Infection rates are highest among young people, so that the illness is most prevalent in individuals in their most productive years. Workers are at risk of having to leave their jobs as they cope with the effects of AIDS, either their own illness or as a caretaker for a sick relative. This can be particularly disruptive to growth when skilled workers are affected. For example, one estimate suggests that up to 30 percent of teachers in Malawi and Zambia are HIV-positive. The direct and indirect costs of the disease also put strains on governments struggling with other social needs such as improving education. Societies will face pressures for increased expenditure on health care. Public and private investment could decline, both because of lower expected profits and because of increased economic uncertainty. One striking indicator of the implications for health care is that an estimated 50 to 80 percent of urban hospital beds in Côte d'Ivoire, Zambia, and Zimbabwe are occupied by HIV-infected patients. This means that these beds are not available for patients with other illnesses. The impact on important social needs is shown by an estimate that treating one AIDS patient costs as much as educating 10 primary school pupils for 1 year.

A few countries have had some success in combating the spread of AIDS. The government of Uganda was one of the first to recognize and respond to the epidemic. It invested heavily in an education and outreach program involving HIV testing, counseling, and treatment. These programs helped reduce Ugandan infection rates by more than 50 percent from 1992 to 1999. Senegal acknowledged the need to

Box 6-1. —*continued*

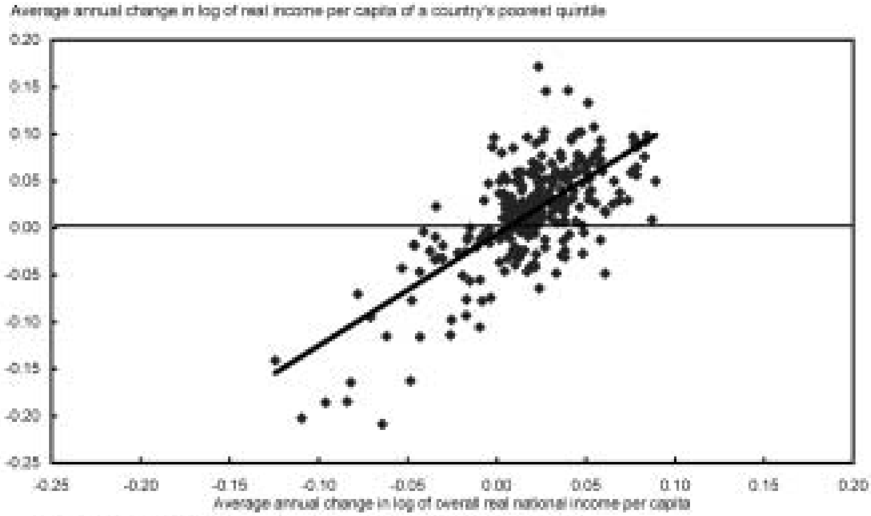
address the AIDS problem as early as 1986 and instituted education and outreach prevention programs. These efforts helped keep the infection rate low (below 1.8 percent), even as infection rates rose dramatically in the country's neighbors. At the end of 2001, only about 0.5 percent of Senegalese adults were HIV-positive.

The scope of the epidemic requires a global response, and the United States has played a major role in this effort. For example, in May 2001 the United States took a leadership position on the Global Fund to Fight AIDS, Malaria and Tuberculosis. The United States now leads the world with the largest pledge, $500 million, to the Global Fund. In 2001 the United States and other WTO members agreed to help developing countries that lack pharmaceutical manufacturing capacity by improving their access to drugs that combat the disease. This access will be increased by ensuring appropriate flexibility in the WTO rules that allow countries to compel licensing of patented medicines in the event of a domestic health emergency. Although final agreement on implementing this commitment has not yet been reached among WTO members, the United States has unilaterally pledged not to challenge any member that breaks multilateral rules to export drugs produced under compulsory licenses to poor countries in need. In June 2002 the President announced a $500 million International Mother and Child HIV Prevention Initiative which will help reduce transmission of HIV from infected pregnant women to their children in 12 African and Caribbean nations. In the 2003 State of the Union address, the President announced the Emergency Plan for AIDS Relief, a five-year, $15 billion initiative to turn the tide in the global effort to combat the HIV/AIDS pandemic. This proposal nearly triples the current U.S. commitment to fighting AIDS internationally.

Bank estimates that 1.2 billion people, or 20 percent of the world's population, still lived on less than $1 a day in 1998. Evidence that economic growth can benefit the poor makes the pursuit of growth-improving policies and institutions all the more vital.

Of course, the relationship between economic growth and measures of the human condition can be complicated. For example, evidence suggests that some measures of environmental quality show consistent improvement as countries become richer. This appears to be the case, for example, with such indicators as the availability of potable water and concentrations of arsenic in water supplies. However, there is also evidence that other measures of environmental quality initially deteriorate, on average, as countries go through

Chart 6-2 **Growth Rates of National Income and Income of the Poorest**
On average, income per capita of the poor (defined as the poorest 20 percent within each country) has risen one-for-one with overall national income per capita.



Note: Data are for 92 developing and developed countries for 1950 to 1999.

Source: David Dollar and Aart Kraay, "Growth is Good for the Poor," *Journal of Economic Growth*, Sept. 2002.

the early stages of development, but then improve once these countries become sufficiently rich. For example, one study finds that the concentration of sulfur dioxide in the atmosphere rises as poor countries begin to industrialize, but then falls as income per capita continues to rise beyond a certain point. Similar results have been found for deforestation and for atmospheric concentrations of particulate matter.

This inverted U-shaped relationship between economic growth and environmental quality could reflect changes in the composition of output. This could happen if countries undergoing industrialization initially specialize in goods-producing industries with relatively high emissions and then eventually shift to services industries, which typically generate lower emissions. The relationship could also reflect the greater ability of richer countries to devote resources to environmental measures, perhaps combined with increased demand for such measures as average incomes rise and people's basic material wants become satisfied.

Promoting Growth

The evidence just laid out suggests that economic growth is critical for improving the lives of millions in the developing world. This leads to some natural questions for policymakers: What can be done to improve growth rates? Why have some countries grown while others remain in poverty? The answers to these questions are critically important for governments of low- and middle-income countries as they try to improve the lives of their people. The answers also have helped the Administration in the design of its three major international economic initiatives, as will be detailed below.

For some countries, economic success may simply reflect their endowment with valuable natural resources such as oil or diamonds. But even countries with large supplies of such commodities can suffer poor economic performance. For example, Nigeria was the fifth-largest petroleum exporter among the OPEC countries over the 1980-2000 period, with average annual oil revenue of $18 billion, yet its average annual per capita growth rate over this period was –1.1 percent. Similarly, Saudi Arabia experienced a growth rate of –2.8 percent over this period despite its immense oil wealth.

Geographic location also influences economic outcomes—the good fortunes of Chile and Botswana notwithstanding. A country's location affects the costs of transporting its goods to major markets, the productivity of its agricultural resources, and the likelihood of major natural catastrophes such as droughts, earthquakes, or hurricanes. For example, one benefit of a coastal location is that it allows access to international sea routes, making transportation of goods far more efficient. One study suggests that, all else equal, landlocked countries have growth rates 1.2 percentage points lower on average than countries with outlets to the sea. Countries in tropical regions apparently face a similar disadvantage: the same study finds that their growth rates average 1.1 percentage points lower than those of countries outside the tropics. The poor average performance of tropical countries is due at least in part to endemic diseases, which can create serious health problems that often have a measurable impact on growth. In Sub-Saharan Africa, for example, health problems associated with malaria alone have been estimated to reduce average annual growth by as much as 0.6 percentage point.

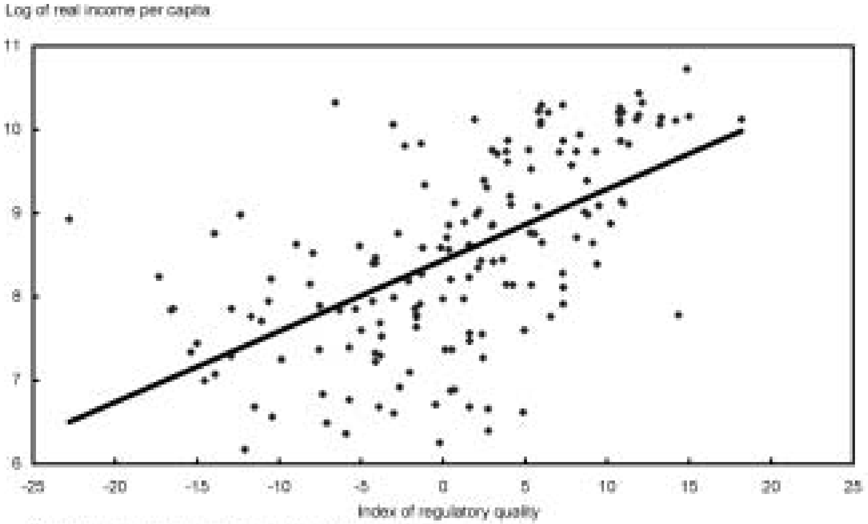
Geography also affects growth indirectly through its effect on institutions, for example through the legacy of European colonization. In those parts of the world where conditions were relatively hospitable to Europeans—for example, where settler mortality rates were low—the settlements that the European countries established tended to have better institutions, such as effective judicial systems and strong property rights protections. Conversely, in regions with high settler mortality rates, such as the tropics, European colonizers tended to invest less in building these pro-growth institutions. The weakness of these institutions continues to inhibit economic performance decades and centuries later.

Clearly, natural resources and geography make a difference for economic outcomes, but they are not the sole determinants. Sound policies and institutions, both of which are shaped by the deliberate decisions of individuals and governments, are also important. In particular, decisions involving the role of government in the economy (economic freedom), the development of political and legal institutions (governing justly), and the health and well-being of the population (investing in people) are all critical in shaping the environment in which people work and invest.

Charts 6-3 and 6-4 show that higher incomes are associated with less burdensome regulation and better protection under the rule of law. Chart 6-3 shows the relationship between income per capita and an index of regulatory quality; the latter is a composite measure, developed by the World Bank, of levels of regulation, government intervention, and price controls within a country, and thus an indicator of economic freedom. Chart 6-4 shows the relationship between income per capita and a similarly constructed measure of the rule of law, which assesses the strength of property rights and the prevalence of crime and corruption; this measure captures aspects of governing justly. Higher positive values of these two measures correspond to a less onerous regulatory burden or stronger rule of law, respectively. The solid line in each chart shows a fitted relationship between the indicated measure and income per capita. Both charts show a clear positive relationship. Of course, a positive correlation between measures of good policies and institutions, on the one hand, and income on the other does not necessarily demonstrate that the former causes the latter—it could be that countries with higher average incomes are better able to afford or demand effective government. But other evidence suggests that, to an important degree, higher income is driven by good policies and institutions, not the reverse. In other words, explicit government decisions, like the decision to enforce the rule of law and to protect property rights, improve economic performance.

Table 6-1 above lists some selected indicators of investment in people and shows their relationship with income per capita. Expenditure on health and education, measured as a percentage of GDP, rises as income increases. The increases in public expenditure on health are particularly dramatic: low-income countries spend less than 1 percent of their GDP on health, compared with 2.9 percent and 6.0 percent for middle- and high-income countries, respectively. Immunization rates for certain major childhood diseases in high-income countries are over 30 percentage points higher than in low-income countries. Public expenditure on education also rises with income, but less dramatically than the health variables. As with the variables discussed above, these figures do not indicate the reason for this positive relationship: whether it is that richer countries can afford to spend more on education and health, or that more investment in education and health leads to higher incomes. But the relationships are suggestive that private and public investment in health and education can be important for growth.

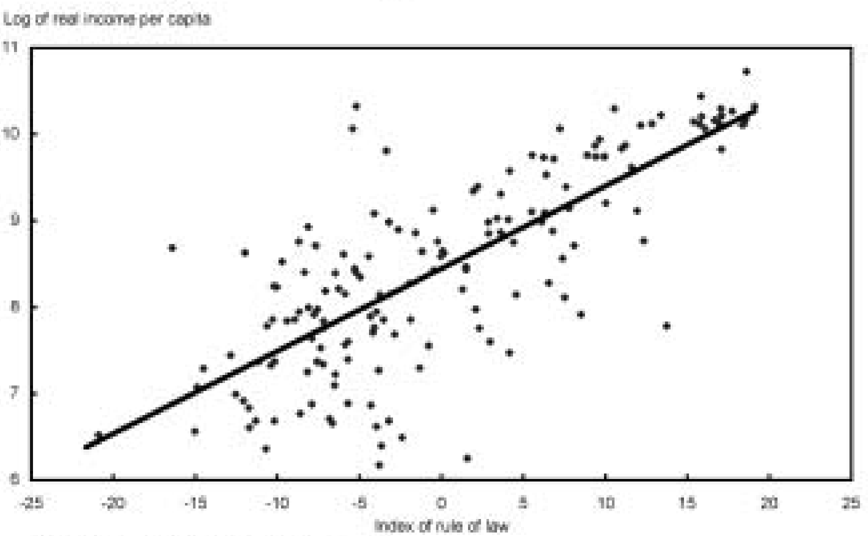
Chart 6-3 **Regulatory Quality and Income per Capita**
Incomes are higher in countries with higher regulatory quality.



Note: Income adjusted for purchasing power parity.

Source: Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobatón, "Governance Matters," World Bank Policy Research Department, Working Paper No. 2196, 1999, using updated data for 2000-2001.

Chart 6-4 **Rule of Law and Income per Capita**
Income levels are higher in countries with stronger rule of law.



Note: Income adjusted for purchasing power parity.

Source: Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobatón, "Governance Matters," World Bank Policy Research Department, Working Paper No. 2196, 1999, using updated data for 2000-2001.

Pro-Growth Principles

This section lays out three critical areas where countries can improve economic performance. Promoting economic freedom helps firms, workers, and consumers respond to market signals. Governing justly helps create an environment in which entrepreneurs, investors, and ordinary people can make economic plans with confidence that the government will not undercut those plans with arbitrary decisions. Investing in people is important for growth because an educated and healthy population is critical for taking full advantage of a society's economic potential.

Economic Freedom: Competition and Entrepreneurship

Economic freedom is fundamental to growth. One of the primary responsibilities of a government pursuing pro-growth policies is to nurture a stable, open economic environment in which market signals direct the allocation of resources. Reliance on the market provides incentives for entrepreneurs to take risks by starting new firms and investing capital in existing ones. Competition from both domestic and foreign sources will require firms to use resources efficiently. Market signals encourage workers to raise their productivity, not because a government instructed them to do so, but because they see it in their own interest. A pro-growth environment is supported by a stable macroeconomic environment, appropriate government regulation, and openness to competition from both domestic and foreign sources, as well as acceptance of foreign direct investment and financial market liberalization.

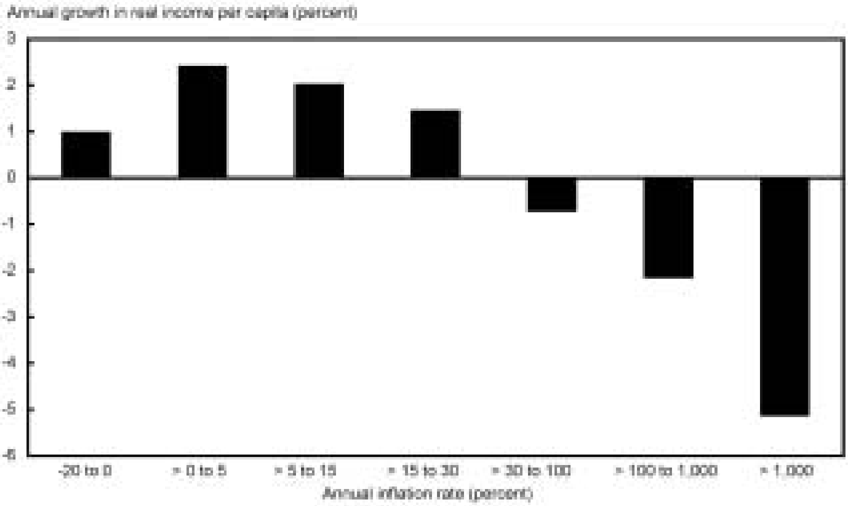
Macroeconomic Stability

A stable macroeconomic environment, characterized by low and stable inflation and responsible fiscal policy, is an important component of a pro-growth framework. Also important is an exchange rate for the country's currency that is not set arbitrarily by the government but reflects market conditions and is sustainable given the country's economic conditions. Macroeconomic stability also facilitates access to international capital markets. Foreign lenders will demand a higher interest rate on loans to an unstable economy, if they lend at all, and foreign equity investors will avoid countries with chronic macroeconomic problems that result in poor returns.

High and variable inflation makes it difficult for individuals and firms to plan for the future; the resulting uncertainty leads to lower consumption and investment and thus slower growth. This connection has been found in many studies, even after taking into account other economic factors such as income, education, investment, and openness to trade, and social factors

Chart 6-5 Inflation and Growth in Income per Capita

Higher inflation is generally associated with slower growth, with the strongest effect for inflation rates over 30 percent.



Note: Data are for 136 developing and developed countries for 1960 to 1994.

Source: Michael Bruno and William Easterly, "Inflation Crises and Long-Run Growth," World Bank Policy Research Department, Working Paper No. 1517, 1997.

such as life expectancy, fertility, and inequality. One study suggests that the adverse effects of inflation on growth in developing countries are greatest when inflation is high. Chart 6-5 illustrates this point by comparing inflation and growth for 136 developing and developed countries from 1960 to 1994. Although higher inflation is associated with slower growth, the effect is most apparent when inflation exceeds 30 percent a year.

Fiscal deficits have been linked to inflation in developing countries, because governments may be tempted to print money to finance large budget deficits. This tendency is particularly problematic in countries with fixed exchange rates. Under a fixed exchange rate regime, the monetary authority must buy or sell domestic currency as economic conditions change, to maintain the official exchange rate peg. If budget deficits lead to excessive domestic money creation through central bank purchases of government bonds, there will be pressure for the domestic currency to depreciate. The monetary authority will then be forced to buy domestic currency with foreign currency to maintain the peg. Because its foreign exchange reserves are necessarily limited, persistent fiscal deficits and the consequent exchange market intervention increase the likelihood of a balance of payments crisis and undercut foreign investor confidence.

Economic growth has been shown to be slower in countries with larger governments, as measured by government purchases of goods and services as a percentage of GDP. Maintenance of an appropriate size and scope of government, with efficient mechanisms for both expenditure control and revenue collection, is vital for economic performance. It is crucially important to give a high priority to strengthening public expenditure management. Improved transparency and accountability, including public expenditure tracking and fiduciary management, are needed to ensure more effective use of domestic and external resources and thus make progress in increasing growth and reducing poverty.

Increased government spending can require higher taxes for its financing, and this has adverse effects on growth, since taxes distort incentives in a well-functioning economy. In particular, taxes alter relative prices, leading to efficiency-reducing economic distortions and slower growth, by interfering with the market's ability to allocate resources.

When governments must finance large expenditures through high taxes, those on whom the taxes are imposed will have an incentive to avoid them. Faced with widespread tax avoidance or evasion, governments might be tempted to turn to schemes that promise to secure revenue but are inefficient and particularly costly to the economy. One such measure now in place in a number of developing countries is the financial transactions tax, a tax levied on bank account withdrawals or deposits (or both). Such a tax creates an incentive for financial transactions to take place outside of the formal financial sector. This reduces financial intermediation, thus shrinking the base from which the tax was designed to garner revenue. Indeed, research on the effects of such taxes in several countries in Latin America has found that the economic efficiency loss has ranged from 30 percent of the revenue collected in Venezuela to 45 percent in Ecuador. Moreover, effective financial intermediation is important for growth for its own sake, so that the adverse effects of taxes on financial transactions extend beyond the direct impact on the efficiency of revenue generation.

Taxes on international trade can be similarly attractive to governments, because the activity to be taxed is localized at a relatively small number of border crossings, ports, and freight yards, making collection relatively easy. But such policies also shield domestic industries from competition while raising costs for domestic firms that rely on imported components. When taxes on imports and exports are high, they create increased incentives for smuggling, which both reduces government revenue and undercuts the rule of law.

As already mentioned, fear of macroeconomic instability decreases the attractiveness of a country to foreign investors. One measure of the private sector's assessment of the macroeconomic situation in a country is the country risk ratings developed by credit analysts. These measures are designed to help investors predict future investment returns. They are based on various measures of macroeconomic stability, including government debt and inflation as discussed above. They also take into account other factors important to growth, including the country's political situation, the level of corruption, the quality of the bureaucracy, the balance of the current account in goods and services, and experience with government expropriation of private investments. These are discussed below.

Regulation, Privatization, and Entry

Government interventions that lower growth rates include onerous or inefficient regulation, government subsidies that distort market signals, direct intervention in production through government-owned enterprises, and government-directed lending. A large body of research has documented the damaging effects of excessive government involvement in the economy in developed and developing countries alike. For example, evidence from 85 countries over the period 1960-85 suggests that, holding constant other factors including the initial level of income, a one-time 10-percentage-point increase in government consumption as a share of GDP is associated with a one-time 1-percentage-point decrease in the growth of GDP per capita.

Privatization of state-owned enterprises has been found to improve growth. In one study of 23 international airlines over 1973-83, privately owned airlines were found to be more productive than their state-owned counterparts: a change from complete state ownership to private ownership increased an airline's rate of productivity growth by 1.6 to 2.0 percentage points a year. Similar results have been found for privatization of public utilities. In Chile, for example, privatization of electric utilities led to more widespread access to electricity among the poor. Before the reform, which began during the mid-1980s, 25 percent of the poorest fifth of the population lacked access to electricity; 10 years later this figure had fallen to about 6 percent.

An important caveat, however, is that privatization alone is not sufficient to guarantee benefits to consumers; competition must increase as well. Otherwise the effect might be simply to replace a public monopoly with a private one, with continued restraints on trade and continued high prices. This problem was highlighted in a study of telecommunications reform in 30 Latin American and African countries from 1984 to 1997: the study found that the benefits to consumers, including lower prices and better service, resulted from increased competition rather than privatization per se.

Governments can enhance competition by reducing regulation on domestic firms that hinders their growth. Often, small producers in an industry, unable to meet the burden imposed by the official business registration process, choose instead to operate informally, that is, without official sanction. A drawback to operating in this way, however, is that these informal producers find it more difficult to raise capital from financial intermediaries within the formal sector, such as banks. This prevents them from growing and competing with the larger, established firms in their industry. In addition, informal producers are less likely to participate in international markets, because they have difficulty obtaining the letters of credit necessary for trade.

In Peru, for example, a study found that about half of all workers were employed outside the formal sector, in part because of the onerous registration fees and other entry requirements faced by their employers. Subsequent research has shown that undue entry restrictions continue to limit business formation in a number of countries, and not only developing ones. One study of 85 countries reports that, in the late 1990s, an entrepreneur starting a new business in Austria needed to complete nine separate procedures, which took at least 37 business days and cost the equivalent of $7,085 in government fees. Bolivian entrepreneurs were required to complete 20 different procedures, pay $2,682 in fees, and wait at least 88 business days to acquire the necessary permits. By contrast, in Canada an entrepreneur could finish the same process in roughly 2 days, paying $280 in government fees and completing only two procedures.

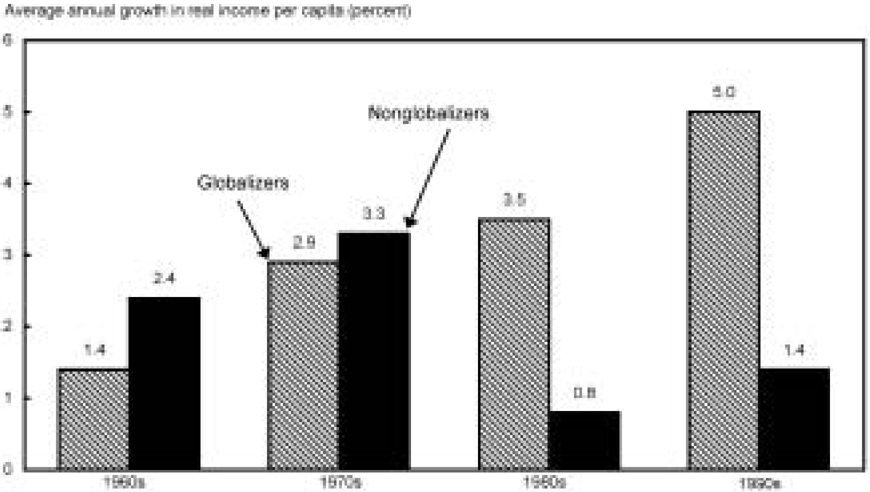
Clearly there are many ways in which government involvement in the economy through regulation can affect economic outcomes. The measure of regulatory quality introduced in Chart 6-3 incorporates the impact of a number of domestic government interventions, including the incidence of price controls, poor bank supervision, and excessive regulation. The World Bank estimates that a 1-standard-deviation improvement in this regulatory quality measure is associated with a threefold increase in growth of GDP per capita.

Openness to International Trade

International trade increases competition and productivity growth. It also brings greater specialization according to comparative advantage, lower prices, and a wider selection of products and services for both consumers and firms. Openness to trade allows exporters to sell their output in a larger market; workers in export industries benefit as the resulting higher prices for the goods they make translate into higher wages and incomes.

Chart 6-6 illustrates the relationship between growth and a measure of openness as estimated in a recent study of developing countries. A sample of 72 developing countries was split into “globalizers” and “nonglobalizers,” with the former defined as the 24 countries in the sample that achieved the largest increases in their trade-to-GDP ratio from 1975 to 1995. In the 1960s and 1970s, the nonglobalizers experienced somewhat faster growth of real income per capita on average than the globalizers. During the 1980s, however, globalizers experienced much higher growth rates: real income per capita grew an average (weighted by population) of 3.5 percent a year in these countries, compared with 0.8 percent for the nonglobalizers. The divergence was even greater during the 1990s, with 5.0 percent annual

Chart 6-6 **Openness and Growth**
In the 1980s and 1990s, developing countries that were more open to the international economy grew faster than those remaining more closed.



Note: Data are for a sample of 72 developing countries split into "globalizers" and "nonglobalizers," with the former defined as the 24 countries that achieved the largest increases in their trade-to-GDP ratio from 1975 to 1995.

Source: David Dollar and Aart Kraay, "Trade, Growth, and Poverty," World Bank Development Research Group, 2001.

growth for the globalizers versus 1.4 percent for the rest. To put these differences into perspective, had the average globalizer and the average nonglobalizer each begun with an income per capita of $1,000 in 1980, by 2000 the globalizer's income per capita would have grown to $2,300, and the nonglobalizer's only to $1,240.

The fact that the latter figure is an average for fully two-thirds of a large sample of developing countries suggests that enormous benefits remain to be reaped from further removal of trade barriers and other distortions that affect trade. These gains are particularly important for developing countries, which are typically too small to affect the world prices of the goods they import or export. If the government of such a country imposes a trade tax, foreigners will continue to buy and sell at the unchanged world price, since they have alternative markets. Consequently, the impact of any trade tax in a small country ultimately is borne by domestic consumers and firms. The tax will lead to lower productivity, lower standards of living, and higher costs of producing goods. Higher barriers in developing countries will also reduce trade with other developing countries, many of which would be natural trading partners under free trade. According to an estimate by the World Bank, developing countries would gain over three times as much from tariff elimination by other developing countries as they would from tariff elimination by developed countries.

An important part of these gains stems from improvements in productivity resulting from lower trade barriers and increased trade. Efficient firms will have an incentive to expand production and increase exports. Increased export production, in turn, results in lower average costs for firms that can exploit economies of scale. Inefficient firms, unable to export to the international market, or under increased competitive pressure from imports, will reduce output or close. A parallel analysis applies to import-competing firms: those that can continue to produce will have an incentive to become more efficient, while less efficient firms will leave the industry. In short, international competition provides incentives to increase efficiency and productivity, leading in turn to higher income per capita. (Chapter 1 further explores the links between productivity and growth.)

Trade liberalization has in fact increased productivity in a number of developing countries. A study of India for the 1986-93 period shows that the trade liberalization that began there in 1991 led to increases in the growth rate of productivity ranging from 3 to 6 percentage points in three out of four industries considered: electronics, electrical machinery, and nonelectrical machinery, but not transport equipment, all recorded gains. Similarly, evidence suggests that productivity growth in Côte d'Ivoire tripled after trade liberalization took place there in 1985. Chilean firms also increased productivity in the wake of trade liberalization in the 1970s and 1980s: industries facing competition from imports experienced productivity gains 3 to 10 percentage points higher than those of industries not engaged in trade. Plants that closed down were on average 8 percent less productive than those that continued to operate.

A further advantage of international competition, in developed and developing countries alike, is that it can reduce the ability of firms to exploit market power, which can reduce productivity and thus growth. Firms insulated from competition, whether domestic or international, not only are free to increase prices to consumers, but also can become inefficient if they restrict output and fail to take full advantage of economies of scale. Studies of India, South Korea, and Côte d'Ivoire suggest as well that domestic monopoly power fell after trade reform, as shown by a drop in price-cost markups and an increase in productivity in many industries. Evidence from India and South Korea indicates that international competition has increased the benefits from more fully exploiting scale economies. Opening to the world market increased production runs and lowered average costs in firms in these two countries.

Barriers to trade can have unintended consequences for the adoption of new, potentially growth-enhancing technologies. In 2000, Brazilian tariffs on data processing and information systems exceeded 20 percent, raising the cost of personal computers and contributing to a rate of computer ownership of only 4 percent of the population. That same year, Costa Rica had a far higher rate of computer ownership (15 percent of the population) than Brazil, in part because of zero tariffs on computers, despite similar income per capita in the two countries ($4,600 in Brazil versus $3,900 in Costa Rica). Brazilian trade policies clearly add to the cost of realizing the productivity gains widely associated with computers.

Although increased trade leads to higher incomes and faster growth for the economy as a whole, it can also mean economic dislocation for some workers. Some firms will shut down, and some workers will lose their jobs or face lower wages as international competition increases. Such dislocation can pose a hardship for those who lack alternative employment near where they live, or whose specialized skills are not easily transferred to other employment. Because such job turnover is an unavoidable part of a growing and dynamic economy, countries must address the social consequences of dislocation, including dislocation due to trade, domestic competition, or technological change. Nor should they do so only for altruistic reasons: countries that have adequate private and governmental institutions to deal with such transition costs will experience fewer pressures to avoid further trade liberalization or other economic reform. (See Chapter 3 for a discussion of new approaches to Trade Adjustment Assistance in the United States.)

This is important, because societies that pursue pro-growth policies such as openness to trade will become richer as a result, and therefore will have the resources they need to deal more effectively with these changes. Countries that instead avoid trade liberalization will face the opposite problem: a fortunate few will see their jobs protected, but many more will have lost real opportunities for improving their lives, perhaps without ever knowing it. The economy as a whole, meanwhile, will experience slower growth and have fewer resources with which to deal with broad social problems.

Foreign Direct Investment and Financial Flow Liberalization

Economic freedom is also enhanced by openness to the flow of capital across international borders. Access to global capital flows provides countries with a means to finance investment projects and the acquisition of new technologies. At the same time, the ability to invest capital abroad helps investors spread their risks and aids in the establishment of new industries. Capital account liberalization, especially in the context of sound banking supervision and financial regulation, leads to improved economic growth, especially in developing countries. One study found that the benefits of capital account liberalization may be twice as great in non-OECD countries as in OECD countries. (The Organization for Economic Cooperation and Development, or OECD, is an association of industrialized market economies.)

Openness to financial flows, low trade barriers, and a good regulatory regime can encourage foreign direct investment (FDI, defined as cross-border flows of capital for the purpose of control of an enterprise). In particular, if foreign firms are able to freely move financial assets and profits into and out of a country, and if tariffs are low on imported inputs, they will be more inclined to set up plants in that country, thus contributing to its growth. A lack of burdensome regulation can also encourage foreign investors to make the commitment to establishing a long-term presence in a country. On the other hand, FDI may be attracted by high tariffs on final goods entering the country; this provides an artificial incentive for foreign companies to avoid the duties by establishing a domestic presence.

Besides bringing in valuable capital, FDI also spurs growth through the management skills, know-how, and new technologies that foreign investors bring into the host country. These advantages have been shown, in both developed and developing countries, generally to result in higher productivity in foreign establishments than in domestic firms, which in turn leads to higher wages in the foreign-owned plants. Mexican manufacturing data for 1970 suggest that both value added and gross output per employee were more than twice as high in plants owned by multinational corporations as in private domestic plants. Estimates from a study of Uruguay in 1988 found that productivity, measured by value added per worker, was twice as high on average in foreign firms as in domestic firms. One study of Indonesian manufacturing found that, in 1996, foreign-owned firms paid wages as much as 20 percent higher for white-collar workers and 12 percent higher for blue-collar workers than did domestic firms.

Financial sector openness coupled with domestic financial liberalization spurs competition among domestic financial firms and between them and foreign participants in the financial sector. This openness exposes the domestic firms to the best practices of world-class financial institutions and exerts pressure on them to adapt quickly. Developed countries, including the United States, have gained from financial market liberalization. In a similar way, developing countries "import" not only the latest bank management technology, but also the best risk management practices, the best work force training, and the newest financial products. Developing countries that are open to the establishment of a foreign financial presence in their economies reap especially important benefits: those with open and competitive financial services markets have growth rates up to 2.3 percentage points faster than those with closed markets.

For many developing countries, reform of the financial sector will require liberalization of domestic laws and regulations to allow foreign firms to provide services in the domestic market on the same terms as domestic financial firms. Transparency will require a mechanism by which firms can review and comment on proposed regulations and obtain easy access to information on existing laws, regulations and licensing, and other requirements in the financial sector. In such a highly regulated area, it is critical that all participants be aware of any changes in the rules or their administration. In addition, effective planning by firms and workers requires that government regulations not change arbitrarily or too frequently. Otherwise investment can be expected to be lower, because the returns will be more risky. Once again, regulatory quality can play an important part in creating an environment in which economic growth can occur.

Efficient financial markets can also help elicit the best results from FDI. In particular, one argument in support of FDI is that it enables residents of the host country to acquire knowledge and learn new techniques while working in foreign-owned plants, and then go to work for (or start) a domestic firm and apply that knowledge there. However, empirical studies have found mixed evidence on whether such technological spillovers systematically occur. If the country's financial system is not well developed (for example, if credit extended by financial intermediaries to the private sector is small in relation to GDP), entrepreneurs may not be able to obtain financing to apply the new knowledge and technology in a new plant. One study of developed and developing countries from 1975 to 1995 suggests that a country's annual growth rate increases by 0.6 percentage point when FDI is undertaken in the presence of well-developed financial markets.

Governing Justly: Rule of Law and Government Accountability

A growing body of research shows that the quality of institutions is critical in explaining differences in growth rates across countries. For example, if domestic legal institutions cannot or do not enforce contracts, businesses and individuals will be less likely to commit to long-term commercial relations, absent informal ties such as family relationships. Government regulation or bureaucratic indifference that makes it difficult to acquire and retain rights to property can slow capital formation. Governments that are unresponsive to their citizens, or that act arbitrarily when making economic decisions, will lose the trust both of the domestic population and of potential foreign investors.

Consequently, countries seeking to accelerate their economic growth must promote institutions that allow individuals and firms to respond to market incentives. The rule of law is one of the most important of these institutions, because it directly affects the willingness of individuals to save and of entrepreneurs to undertake commercial activities.

If the rule of law is to provide an environment supportive of growth, it must encompass not just what is commonly thought of as "law and order," but also, more broadly, the protection of property rights, the ability to make and enforce contracts, and the ability to settle private disputes fairly and effectively. People must also have reason to expect that the government will not intervene in legitimate private transactions by expropriating property, systematically favoring either debtors or creditors, or supporting one sector of the economy over another in legal proceedings. Returns on investment have been found to be higher in countries with strong rule-of-law protections. For example, one study concluded that rates of return on World Bank-financed projects over the last several decades were 8 to 22 percentage points higher in countries where the rule of law was well established than in countries where it was not. Another study of 115 countries from 1960 to 1980 found that, on average, income growth was nearly three times as rapid in countries with greater civil liberties and political freedoms as in countries that were less free.

Enforcement of property rights is an important aspect of the rule of law, regardless of a country's income. Legally held assets, legitimate investments, and profits from legal commercial transactions must be protected against seizure by criminals—or by governments without compensation. Countries whose governments do not enforce property rights can be expected to suffer from slower growth. To see this, consider the economic effects of a government that routinely seizes private resources without legal justification or adequate compensation. Investors, assessing the risk of expropriation of their assets, will then require a higher rate of return on any projects they undertake, and some investment that would otherwise bring economic benefits to the country—higher income, higher productivity, higher wages—will be forgone.

The poor may be especially hurt by the absence of property rights. Many of the poor in the developing world lack formal title to what property they have, which means they cannot use it as collateral to borrow to expand their informal businesses or establish a new enterprise. In addition, they often must rely on extralegal means to insure against appropriation of their investment by others, because they cannot rely on the formal legal system to protect their property.

Institutions that protect property rights are crucial for economic growth. One study links the successful development outcomes in East Asia over the past several decades to the quality of institutions and property rights there. Examining eight countries in the region over the period 1960-94, researchers found important contributions from just three variables: institutional quality, initial income, and initial education. Those countries with the weakest institutions—Indonesia and the Philippines—had the slowest growth.

Inadequate legal protections for passive or minority investors also affect investment and growth. One reason is that, in countries with weak investor protection, managers may be able to exploit inside information about their firms, to the disadvantage of outside investors. Knowing this, investors will be less willing to commit funds in the first place. A study of individual firms in 38 developing and developed countries over the period 1988-98 found that countries with weak protection for outside investors had capital stocks only half as large as countries with strong investor protections.

The rule of law is particularly important for the development and efficiency of the financial sector. For example, banks cannot function effectively without strong institutions that support the rule of law. Modern banking depends on the confidence of depositors that banks will safeguard the monies in their trust and that the government will provide supervision and regulation to ensure the banks' soundness. Reforms that strengthen creditor rights, contract enforcement, and accounting practices boost financial development, and with it economic growth. One study shows that if countries improve the legal protection of creditors, they will have much stronger financial development, which in turn accelerates long-term growth. Another study found evidence that the positive impact of capital account liberalization on growth (as described above) is enhanced through institutions that promote the rule of law.

Of course, the nature of laws and institutions matters—the laws must be appropriate and the institutions effective. The laws and institutions governing bankruptcy proceedings provide an example. In a number of developing countries, the lack of sound bankruptcy law, effective bankruptcy courts, and other institutions effectively prevents creditors from enforcing their claims on bankrupt debtors, even when their loans are collateralized. Without the ability to collect on collateral, financial institutions will require higher interest rates on any loans they offer, effectively hampering access to credit for firms throughout the economy. The greatest impact may well be on smaller firms seeking to grow but unable to finance investment projects solely from internal cash flow. The importance of bankruptcy institutions is confirmed in a recent study of 43 countries: researchers found that differences in laws related to investor protection were attributable to the historical origin of countries' legal systems (for example, English, French, German, or Scandinavian), and that these differences had lasting effects. In those countries whose legal systems make it difficult for creditors to seize collateral secured against bankruptcy, credit extended to private firms was lower as a share of GDP than in other countries. Reduced availability of credit can be expected to translate into higher real interest rates in these countries, and thus lower rates of investment and growth.

When the rule of law is weak, corruption can flourish, and this, too, leads to slower growth. Corruption affects growth through a number of channels, including tax evasion, distorted investment decisions, and suppression of legitimate business. Corrupt officials add to the damage of inefficient regulations, because bribes then determine what economic activity is approved. Corruption represents a tax on economic efficiency and social progress and is an enormous barrier to both domestic and foreign investment.

Corrupt individuals in the private sector may conspire with corrupt officials to avoid taxes, depriving the government of needed revenue. The result is likely to be higher tax rates on a smaller base, which can cause economic distortions. For example, a study of 39 Sub-Saharan African countries covering the period 1985-96 found that a 25 percent increase in corruption led to a decrease in tax revenue of 2.1 to 2.8 percent of GDP.

Corruption can harm growth more directly by limiting investment and entrepreneurial activity. Corruption increases risk and uncertainty, which reduce the incentives to invest. A further channel for corruption is the diversion of resources intended for public infrastructure to the private consumption of corrupt officials. This leads to less investment and slower growth. One study of 57 developing and developed countries found that a one-third decrease in corruption was associated with an increase in the investment share of GDP of 2.9 percentage points, and an increase in annual growth in income per capita of 0.8 percentage point. Corruption can also retard the development of legitimate business. A study of Ugandan firms using data from 1995 to 1997 found that a 1-percentage-point decline in the rate of bribery was associated with an increase in firm growth of about 3.5 percentage points.

The quality of political institutions can also play a role in economic outcomes. In particular, increasing citizens' voice in determining political decisions and ensuring the accountability of public officials fosters a more responsive government and strengthens the rule of law. A responsive and responsible government will gain the public's trust and create more incentives for private investment. One study that attempted to assess the economic impact of these factors estimated that an increase in a measure of "voice and accountability" was associated with a marked increase in GDP per capita. Studies using broader measures of government effectiveness that incorporate individual freedoms, regulatory quality, and the amount of bureaucracy in a country have yielded similar results: an increase in a measure of government effectiveness corresponded to a marked increase in GDP per capita. Strong civil liberties and overall government effectiveness also have an impact on other social indicators: countries that score higher on voice and accountability and on government effectiveness tend to have lower infant mortality and higher literacy rates.

Investing in People: Health and Education

Investment in human capital is also important for economic growth. Well-trained and healthy workers are more likely to make the greatest possible use of the physical stock of capital in any country.

Formal education is a direct way to invest in human capital, and there is some evidence of a positive relationship between national income and educational attainment. In 2000 the average duration of schooling in low-income countries was 4.4 years (3.3 years for females), compared with 10 years in high-income countries (9.8 years for females). In a cross-country analysis of

98 developing and developed countries covering 1960-85, a 1-percentage-point increase in the primary school enrollment rate was associated with a 2.5-percentage-point increase in growth in income per capita.

Education is most effective in an environment in which the investment in time, effort, and money devoted to education leads to higher returns from increased labor productivity. If a society's high-paying jobs are awarded based on political connections or family and ethnic ties, those excluded from such jobs will have less incentive to pursue their education, which in turn will lead to slower economic growth. Similarly, if a country's best-educated young people find employment in inefficient state-owned enterprises or bureaucracies (as was the case in the centrally planned Soviet Union, for example), the impact of education on labor productivity will diminish. Empirical results from research on 12 Asian and Latin American countries over 1970-94 are consistent with this hypothesis. In particular, the effect of education on growth was found to be negligible in closed and highly regulated economies; in countries that had undertaken free market reforms, however, a 5 percent increase in educational attainment was associated with a 0.9-percentage-point increase in the annual growth rate.

There are important caveats to the conclusion that higher educational achievement necessarily leads to faster growth. One difficulty is that the links between formal education and growth are complex. For example, some evidence suggests that the positive relationship between education and growth arises in part because growth leads to increased schooling. This could happen if the expectation of strong growth in the future leads to an increase in the demand for schooling today, as individuals sacrifice current earnings for higher wages in the future.

Education and the development of good institutions can be mutually reinforcing. Good institutions and policies can lead to higher returns on education and faster growth, and in turn, a well-educated population is an important element in developing good institutions. An illiterate population, for example, may be less likely to hold political leaders accountable, because it is hard to acquire information about poor policies and outcomes if one cannot read. An educated population is likely to be a well-informed population, and one that can exert pressure for sound policies and institutions.

Effective health care is also important for improving the quality of the work force and increasing economic growth. Healthy employees are absent from work less often, and the resulting higher utilization of capital leads to lower average costs and faster growth. Healthy workers also tend to earn higher wages, indeed more so in developing countries, where manual labor plays a larger role in the economy, than in industrialized and services-intensive developed countries. One study of 104 countries found direct evidence linking health and growth, suggesting that increasing average life expectancy (a standard indicator of a population's general health) by 1 year can lead to a 4 percent increase in national income. This result suggests that countries with severe health problems and lowered life expectancy will have slower growth than they could otherwise achieve. The problem is particularly acute in low-income countries that face challenges associated with infectious diseases such as malaria and HIV/AIDS. (See Box 6-1 above.)

It is well established that countries with higher incomes have longer life expectancies, lower maternal mortality rates, and higher average birth weights. Determining the causal link between income and health is difficult, however, for reasons similar to those for income and education: on the one hand, countries with higher incomes can devote more resources to health care, but on the other, better health outcomes improve productivity and raise growth rates.

Health and education outcomes, of course, can be interlinked. Sick children are more likely to be absent from school, and this can lead to lower educational achievement and lower income later in life. For example, school-age children are especially susceptible to infestation by parasitic worms. Recent estimates suggest that as many as one in four people worldwide are afflicted with various types of worms; severe infestations can lead to anemia, malnutrition, and listlessness. A study of a joint public and private project in Kenya found that treatment with de-worming drugs led to a 25 percent reduction in primary school absenteeism and was cost-effective: the net present value of increased wages from increased school participation far outweighed the cost of treating the children. This suggests that effective programs to invest in people can lead not only to healthier children, but also to improved participation in schooling and ultimately to higher wages.

The Administration's Policies to Enhance Growth

The discussion thus far has made it clear that creating the right environment for growth in developing countries requires, above all, actions by those countries themselves. To complement and reward their efforts, the Administration has put forward three initiatives that will spur growth in developing countries and elsewhere by helping to create an environment in which incentives can improve economic opportunities. Trade Promotion Authority will help the President conclude trade agreements that will further integrate developing countries into the global marketplace and increase growth. The Millennium Challenge Account will increase development aid to countries that are pursuing policies and building institutions that adhere to the principles of good governance. The Administration's proposals to redirect the funds and priorities of the multilateral development banks will also help developing countries improve their growth prospects.

All three initiatives are consistent with the pro-growth principles that this chapter has laid out. The Administration's focus, under TPA, on trade liberalization within a rules-based system is based on the principle of openness to goods and capital flows, as well as the promotion of legal institutions and the rule of law. The MCA incorporates all of the principles described above by integrating them into the criteria used to determine the awarding of grants to developing countries. Reform of the MDBs will encourage private sector growth and effective economic management in the countries they serve.

Trade Promotion Authority

The significance of TPA is that it enhances the President's ability to negotiate trade agreements, by assuring foreign governments with which the United States negotiates that the Congress will vote yes or no on those agreements without amendment. The Congress retains its primary constitutional authority to regulate foreign commerce, and the Administration will continue to consult Members of the Congress frequently on matters relating to the course of trade negotiations.

The agreements made possible by TPA will benefit the United States by creating new export opportunities and lowering prices for imported goods and services. But TPA will also foster growth in developing countries by increasing competition. The rules-based agreements will also promote institutions in developing countries that will help them take full advantage of trading opportunities.

The increased integration of developing countries into the global marketplace has already brought those countries enormous benefits. Research suggests that a 1 percent increase in a country's trade relative to its GDP is associated with an increase in its income per capita of 3 percent. Moreover, evidence suggests that it is increased trade that leads to increased income rather than the reverse. A recent study suggests that the full implementation of trade liberalization under the Uruguay Round of multilateral trade negotiations, completed in 1994, increased developing countries' income by 0.8 percent, double the percentage increase accruing to the developed world. India's GDP is estimated to have risen an even greater 1.1 percent of GDP as a consequence of the same liberalization commitments.

Further trade liberalization will continue to raise world income. A recent World Bank study suggests that the elimination of all tariffs, export subsidies, and domestic production subsidies on goods would raise annual world income by $355 billion by 2015, with middle- and low-income countries receiving 52 percent of that increase. Another study suggests that if world barriers to trade in agricultural and industrial products and to trade in services were reduced by one-third, the gains to the United States alone would translate into additional annual income of $2,500 for the average American family of four.

The President's new trade negotiating authority has already resulted in the successful completion on the substance of free trade agreement (FTA) negotiations with Singapore and Chile. These agreements cover a wide range of issues, including, among others, the eventual elimination of tariffs, increased openness to trade in telecommunications and other services, transparency requirements, protections for foreign investors, and provisions for enforcement of labor and environmental standards. One study suggests that although the net benefits to the United States from these two FTAs will be relatively modest (0.05 percent and 0.18 percent of GDP, respectively), the benefits to Chile and Singapore will be proportionately greater (0.6 percent and 2.7 percent of GDP, respectively).

TPA will provide an impetus to conclude a number of other trade agreements currently under negotiation, most of which are with developing countries. These negotiations include the ongoing discussions with countries in the Western Hemisphere toward a Free Trade Agreement of the Americas (FTAA) and the recently inaugurated talks with Australia, Morocco, the countries of Central America (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua), and the countries of the South African Customs Union (Botswana, Lesotho, Namibia, South Africa, and Swaziland). The commitment of the United States to conclude these talks under TPA reflects the Administration's determination to advance pro-growth trade liberalization, especially in the developing world.

The FTAA, in which 34 countries in North, Central, and South America will participate, is the most complicated and far-reaching of the regional trade agreements toward which the United States is currently negotiating. One study suggests that, when the FTAA is in place, the United States could experience a 0.6 percent increase in GDP, and the combined GDPs of the Latin American participants (excluding Mexico and Chile) could increase by 1.1 percent. The same study suggests that Mexican and Chilean GDP would rise by 0.8 percent and 2.5 percent of GDP, respectively, as a result of the FTAA.

As with the FTAs with Chile and Singapore, the benefits of these bilateral and regional agreements are proportionately larger for other countries than for the United States, although smaller in absolute dollar terms. The reason for the asymmetric effects is straightforward: the U.S. economy is so large relative to these trading partners that the economic benefits of FTAs with them will be small as a share of U.S. economic activity. In addition, U.S. trade barriers are already low on average, so that the impact at home of further trade liberalization will be modest. For example, the U.S. economy in 2001 was 151 times larger than the Chilean economy, and trade in goods with Chile (exports plus imports) amounted to only 0.4 percent of total U.S. trade. U.S.

tariffs in 2001 averaged 1.6 percent, compared with average Chilean tariffs of 8 percent; thus the costs of current trade barriers fall more heavily on Chile. However, U.S. exporters of goods and services and U.S. investors will be able to operate more freely in a fully liberalized Chilean market.

Despite their modest effects in relation to total U.S. output, these agreements are important to the United States as part of the broader U.S. effort toward multilateral reduction in trade barriers under the auspices of the World Trade Organization (WTO). TPA will be especially important for the United States and developing countries by helping bring the current WTO negotiations to fruition. The importance of further integrating developing countries into the world trading system is reflected in the name given to these negotiations: the Doha Development Agenda. (Doha, the capital city of Qatar, is the site of the WTO ministers' meeting where the agenda was launched.)

The United States has offered bold proposals in the Doha negotiations for the reduction of trade barriers on agricultural and nonagricultural goods. The agricultural initiative proposes to reduce agricultural tariffs, limit governments' support of agriculture to 5 percent of the domestic value of production, and eliminate agricultural export subsidies. The Administration has also proposed that, by 2010, WTO members eliminate all tariffs on nonagricultural goods that are currently below 5 percent and sharply reduce the rest, including those on textiles and apparel. Going further, the Administration has proposed that all nonagricultural tariffs be eliminated in all WTO member countries by 2015.

The reduction and eventual elimination of tariffs on goods is but one aspect of the U.S. trade liberalization agenda in the WTO negotiations. The United States has put forth over a dozen proposals to reduce barriers to trade in an array of services industries. In addition, the United States has advocated greater regulatory transparency, both through general disciplines and through rules applicable to specific industries, such as financial services. This initiative reflects the assessment, discussed above, that regulatory quality is key to economic outcomes.

These liberalization initiatives will bring important benefits to U.S. firms, workers, consumers, and farmers, both from increased exports and from lower priced imports. The U.S. agricultural and nonagricultural market access proposals are of particular importance to developing countries, since many expect to increase their exports of agricultural goods as well as textiles and apparel to developed countries if barriers are reduced. However, developing countries can also expect important efficiency gains and faster growth as they remove their own barriers.

The economic effects of the current WTO negotiations cannot be examined in detail until the outlines of the final agreement become clearer. One study provides some sense of the possible outcome, however, by analyzing a hypothetical 33 percent reduction of trade barriers across all sectors. In this scenario U.S. GDP rises by 2 percent, that of Europe (the countries of the current European Union and the European Free Trade Area combined) by 1.5 percent, and that of Japan by 1.9 percent. The same study also predicts large increases in GDP in developing countries, including the Philippines (5.4 percent), South Korea (2.5 percent), Mexico (1.8 percent), Chile (2.4 percent), the rest of Latin America (1.4 percent), and the Middle Eastern and North African countries (1.9 percent).

These estimated effects of trade liberalization take into account only its static impacts, such as a reallocation of resources to more efficient uses and the benefits accruing to consumers from lower prices. The estimates do not capture the dynamic effects on growth, such as those arising from greater economies of scale, productivity gains, and access to improved technologies, that increased openness would bring. Including these effects could substantially boost the impact of trade liberalization. For example, the World Bank study previously cited found that, by 2015, world income would increase by another 134 percent, with 65 percent of that increase going to developing countries, in response to the multilateral elimination of all trade barriers. Thus, including dynamic effects increases the impact of liberalization but also increases the potential benefits accruing to developing countries.

The conventional estimates also typically fail to capture gains in services trade, in large part because quantifying barriers to such trade can be difficult. Nonetheless, services are becoming more important to developing countries, with their average share in GDP rising from an estimated 40 percent in 1965 to 50 percent in 1999. Removing barriers to services leads to lower costs and greater efficiency in such important sectors as telecommunications, e-commerce, transport services, professional services, and financial services. A World Bank study suggests that multilateral liberalization in the services sector alone would increase combined developing-country GDP by nearly $900 billion, a gain nearly five times greater than the anticipated benefits of merchandise trade liberalization.

Of all the trade liberalization initiatives currently on the agenda, the United States and its developing-country partners stand to gain the most from completion of the WTO negotiations, but the bilateral and regional agreements will also bring benefits. For example, a 33 percent cut in all global tariffs could lead to gains in U.S. and Chilean GDP of $177 billion and $1.9 billion, respectively, and an increase in world GDP of $612 billion. The U.S.-Chile FTA would increase U.S. and Chilean GDP by $4.2 billion and $479 million, respectively.

Some have argued that a focus on regional and bilateral trade liberalization could undermine the broader process of multilateral trade liberalization and the WTO as an institution. However, the Administration sees these bilateral and regional agreements as part of a strategy of "competitive liberalization," that is, as steppingstones to worldwide trade liberalization rather than as a stumbling block. In other words, the bilateral, regional, and multilateral prongs of the Administration's strategy for trade negotiations are intended to work in concert, to help achieve the broadest possible degree of trade liberalization in the United States itself and among the greatest possible number of its trading partners.

Trade agreements negotiated by the United States have had, and will continue to have, other indirect benefits to economic performance. The rules-based nature of modern trade agreements helps encourage the development of institutions consistent with the pro-growth principles enunciated in this chapter. In particular, transparency, rule of law, contract enforcement, and property rights are all part of recent U.S. rules-based trade agreements. The introduction of bilateral and multilateral trade and investment commitments can help transform economies in ways that foster these pro-growth policies. For example, rules-based trade agreements enhance the transparency of government actions. Trade commitments must be cataloged, organized, and made public, not only to trading partners but also, ultimately, to domestic constituencies. As citizens become accustomed to public transparency and accountability in trade policy, they may be more likely to demand similar transparency in other aspects of their country's public policy. Such accountability limits government's ability to make arbitrary decisions and thus ultimately creates better conditions for strong growth. In some respects, domestic reforms reinforced by the rules-based trading system have already taken hold in China (Box 6-2).

Trade agreements also encourage the rule of law and the enforcement of contracts. All such agreements require that governments write down their rules governing trade, and in most agreements, governments agree to submit trade disputes to external review by third-party panels. Governments that know that their actions can be reviewed by external and impartial dispute settlement bodies may be less likely to enforce laws arbitrarily. Similarly, foreign firms can resort to a dispute settlement panel if a trading partner fails to enforce legally binding contracts. As domestic firms and individuals become more familiar with the legal procedures available to foreigners within the country, they may pressure their government for similar nonarbitrary decisions and legal protections in internal matters. Once again, the external commitment may help with internal reform.

A rules-based system also fosters the development of protection for property rights, especially through agreements that cover FDI. Many trade agreements, including the North American Free Trade Agreement and the bilateral FTAs between the United States and Israel and Jordan, and now Chile and Singapore, contain protections against uncompensated expropriation by

Box 6-2. China, the WTO, and the Rule of Law

The accession of the People's Republic of China to the World Trade Organization in December 2001 should strengthen and accelerate the economic reforms launched by the Chinese government over 20 years ago. These reforms not only have increased trade and investment dramatically but also have enhanced transparency and decreased state control over the economy. The benefits of economic liberalization and reform can be seen in the huge reduction in poverty and dramatically increased income per capita in China since 1980.

China's integration into the world economy has been one of the most dramatic events in the recent wave of globalization. In 1980 China's total goods exports and imports amounted to only $37.8 billion. Exports were tightly controlled by the various state bureaucracies. Foreign direct investment was essentially nonexistent. Beginning in the early 1980s, China began to move away from formal trade planning and toward market-based trade incentives. Tariffs and nontariff barriers replaced quantitative planning, foreign direct investment was welcomed in many sectors, and encouraging exports became a prime motivating factor in Chinese economic policies. Although China's policies remained far from textbook free trade during the early years of integration (China's average tariff rate in 1982 was 56 percent), the dramatic shift in economic policy created far-reaching new economic opportunities.

By 2001 these reforms had brought enormous changes to the Chinese economy. Exports of goods had grown to $266 billion, a 14-fold increase since 1980. Imports of goods expanded from less than $20 billion to $244 billion over the same period. Average tariffs had fallen to 15 percent by the time of WTO accession. Annual foreign direct investment flows had risen from $430 million in 1982 to over $38 billion in 2000. Income per capita had risen from $167 in 1980 to $824 in 2000.

China's efforts to gain WTO membership led to external pressure for extension of the rule of law and more transparent decisionmaking in the country. For example, during the 1990s the United States informed the Chinese government that failure to protect copyrighted materials such as software, films, and other recordings would undercut U.S. support for China's membership. China finally agreed to begin to enforce intellectual property rights laws in 1996, but its enforcement efforts still need to be strengthened.

China's formal accession to the WTO will lead to further reform. By mid-2002 approximately 830 existing laws and regulations had been repealed, 325 amended, and 118 new laws and legislation adopted in order to bring China into conformity with WTO rules. With its new WTO

Box 6-2.—*continued*

obligations, China has now made a formal external commitment to a whole range of trade-related reforms. Failure to live up to these commitments will put Chinese exports at risk in other WTO members' markets, because members may enforce China's commitments through WTO dispute settlement proceedings and may retaliate if China refuses to cease its actions deemed WTO-inconsistent. For example, China is adopting regulations for controlling injurious dumping of imports, as WTO rules allow. Whereas in the past bureaucrats could restrict imports arbitrarily, however, Chinese antidumping procedures henceforth will be carefully scrutinized by other WTO members for inconsistency with WTO rules.

China has undergone enormous changes in its economic orientation over the last 20 years. Membership in the WTO brings with it an external commitment to this process of reform and makes a return to a centrally planned economy even more difficult.

governments. As these commitments to U.S. firms become widely known, domestic firms in those countries may expect similar guarantees.

The United States also extends special benefits to certain low-income countries through various programs including trade capacity building assistance, the Generalized System of Preferences, the Andean Trade Preference Act, and the African Growth and Opportunity Act (AGOA). AGOA, which was signed into law in May 2000, reduces trade barriers for Sub-Saharan African countries' products entering the United States below those required under the multilateral trade commitments negotiated under the WTO. However, countries in this region do not automatically qualify for lower U.S. tariffs. To be eligible, a country must have a market-based economy, and its government must be making efforts to limit its interference in the economy and must protect property rights. In addition, the government must undertake economic policies that aim to reduce poverty, improve health, and promote private enterprise. Finally, eligible countries must be taking steps to combat official bribery and improve labor rights. In short, through AGOA the United States offers lower trade barriers to poor countries in Sub-Saharan Africa that are making efforts to pursue good policies and promote good institutions. The principles behind AGOA are thus very similar to those of the second major new Administration initiative, the Millennium Challenge Account, which is discussed next.

The Millennium Challenge Account

In March 2002 the President proposed a new program designed to promote growth in developing countries. Over the next 3 years, the Millennium Challenge Account will increase annual U.S. bilateral development assistance by $5 billion, a 50 percent increase over current levels. MCA funds will be used to support activities that directly contribute to economic growth and poverty alleviation. MCA programs will be implemented by the private sector, nongovernmental organizations, and public sector agencies. The MCA will strive to achieve within recipient countries a broad coalition around development investments. Because MCA aid will be in the form of grants, not loans, in accordance with the policy set forth by the President at the Group of Eight summit in 2001, this development assistance will not increase the debt burden of recipient countries.

The MCA is based on the fact that development assistance is most effective when funds flow to countries that have already adopted policies and created institutions that promote growth. In other words, only those countries that have taken concrete steps themselves to improve their condition will be potential MCA recipients. The MCA approach has the added advantage that, as countries strive to qualify for U.S. grants, they will be implementing policies that also encourage inflows of private capital and increased trade, the real engines of sustained economic growth.

Countries receiving MCA assistance must be active partners in the development programs funded by the MCA. Each country selected for aid will negotiate and sign a contract with the MCA, which will specify the following: a limited number of clear, quantifiable goals; concrete benchmarks that specify the time needed to accomplish the tasks; commitments to financial accountability; and conditions under which the contract would be terminated. MCA resources are meant to complement and enhance specific efforts and policies undertaken in the participating countries; indeed, the MCA program will not impose a development plan designed by others, but rather recognizes that the countries themselves are in the best position to evaluate their own needs. In short, MCA recipients must take responsibility for their own development programs.

Monitoring and evaluation to ensure accountability for results will be an integral part of every activity for which MCA funds are used. Monitoring and evaluation will be conducted by the MCA administrative structure or by third-party contractors, or both. To facilitate such monitoring, all contracts will include baseline data against which progress can be measured. The U.S. Government will provide technical assistance to help countries establish these credible baseline data. Every contract will specify regular benchmarks for evaluating progress and provide for the corrective actions necessary to keep the program on track. All evaluations and all terms of the contract will be made public in the United States and in the host country.

MCA contracts will fund projects for a limited term and include provisions for a midterm review. Programs will continue to receive funding under the terms of the country's MCA contract unless the country fails to meet the contract's conditions for performance. Funding for all or part of a particular MCA contract may be scaled back or ended for failure to meet financial standards or specific benchmarks. In addition, a country's participation in the MCA may be terminated for failure to adhere to the three fundamental principles laid out earlier in this chapter—economic freedom, governing justly, and investing in people—as indicated by an absolute decline in the policy environment. Participation may also be terminated in the event of material change such as a military coup.

Allocation of MCA resources will be based primarily on quantitative benchmarks in order to ensure procedural accountability and transparency. These criteria will focus on the three broad principles just mentioned. Use of published, quantitative measures will also help countries understand why they did or did not qualify to receive MCA funds. This knowledge will enable countries to identify where they need to improve their policies in order to qualify for future grants. Table 6-2 lists the 16 specific indicators (and the initial public sources for the data) for the three MCA principles. These indicators were chosen because of their quality and objectivity, country coverage, and public availability.

TABLE 6-2.—*Millennium Challenge Account Indicators*

Principle	Indicator	Source
Economic freedom	Country credit rating	*Institutional Investor* magazine
	Inflation	International Monetary Fund
	Budget deficit	International Monetary Fund, national sources
	Trade policy	Heritage Foundation
	Regulatory quality	World Bank
	Days needed to start a business	World Bank
Governing justly	Control of corruption	World Bank
	Rule of law	World Bank
	Civil liberties	Freedom House
	Political rights	Freedom House
	Voice and accountability	World Bank
	Government effectiveness	World Bank
Investing in people......	Public primary education spending as percent of GDP	World Bank, national sources
	Primary education completion rate	World Bank, national sources
	Public expenditure on health as percent of GDP	World Bank, national sources
	Immunization rates: DPT and measles [1]	World Bank, national sources

[1] Immunization for diphtheria, pertussis, and tetanus and for measles.

Source: Millennium Challenge Account fact sheet, The White House.

As described previously, economic freedom broadly encompasses the freedom to start a business, hire workers, invest, and make other business and personal decisions without undue government interference. In the MCA process, economic freedom will be measured by six publicly available criteria: country credit ratings, inflation rates, budget deficits, measures of openness to trade, measures of regulatory quality, and the number of days it takes to start a business. Country credit ratings are included because they contain useful summary evaluations by private sector sources of the country's macroeconomic situation. Inflation rates and budget deficits are included to capture those aspects of macroeconomic stability so important to growth. Trade policies, including the degree to which imports are subject to tariffs and nontariff barriers, as well as the extent of corruption in the national customs service, will measure the extent to which a country's policy environment allows it to take advantage of global markets. Finally, regulatory quality and the time it takes to start a new business provide quantitative measures of the environment for entrepreneurial activity.

The second principle—governing justly—involves various facets of good governance and good institutions that help sustain a pro-growth environment. The inclusion of criteria that embody this principle reflects the important complementary role of the quality of institutions in improving economic performance. The criteria will measure the extent to which citizens of a country are able to participate in the selection of governments, the freedom to develop views and institutions independent of the state, the role of elected representatives in policy formation, the control of corruption, and the rule of law. These are important indicators of whether there is political accountability in the country.

Measures of governing justly will be based on surveys by the World Bank and Freedom House, a nonprofit, nonpartisan organization. Rankings will be based on the following criteria: civil liberties, political rights, voice and accountability, government effectiveness, rule of law, and control of corruption. Assessment of the rule of law, which, as discussed above, is important to investor and entrepreneurial confidence, will cover such factors as the effectiveness of the judiciary and the enforceability of contracts. Ratings of political rights and civil liberties will be determined through a compilation of foreign and domestic news reports, publications by nongovernmental organizations, policy center research, and academic and professional analysis.

The third principle—investing in people—involves public commitment to developing human capital through education and improved health. Here the quantitative criteria include public spending on primary education as a percentage of GDP, the share of children who have completed primary school by the national graduation age, public expenditure on health as a percentage of GDP, and immunization rates of children under 12 months for DPT (diphtheria, pertussis, and tetanus) and measles. The importance of education in maintaining and improving worker productivity is reflected in the inclusion of both a public education input (public spending on primary education) and an education output (the share of children completing primary school). As noted in the earlier discussion of pro-growth principles, improved health care is also important to better economic outcomes. Consequently, public expenditure on health care is included as an MCA criterion, along with immunization rates for some of the most common serious childhood diseases worldwide.

Countries must demonstrate commitment to and performance on all three principles to be deemed a "better performer" and thereby qualify for possible MCA assistance. Eligibility will be limited to those countries that score above the median on at least half of the indicators in each of the three areas. However, countries must score above the median on the corruption indicator to be considered for grants, regardless of their scores on other criteria. This requirement reflects the importance that corruption plays in whether or not development assistance achieves its aims. As noted above, reducing corruption supports the benefits of other good policies and of development assistance by building public trust in institutions, encouraging investment, and helping ensure that aid is put to pro-growth uses.

Candidate countries will be evaluated within one of two income categories. Initially, only countries with gross national income per capita below $1,435 (in 2001 dollars) will be eligible for grants. This level was chosen because it is the historical income threshold for assistance to the world's poorest countries from the International Development Association (IDA), the World Bank affiliate that specializes in assistance to the poorest countries. In subsequent years, the income threshold for eligibility will be raised to $2,975, the projected cutoff for the World Bank's designation for lower-middle-income countries. However, the two income groups (those with incomes per capita below $1,435 and those with incomes between $1,435 and $2,975) will continue to be evaluated separately. This separation is important because, as discussed above, higher income is associated with better social and economic indicators. Grouping the countries in this way will ensure that countries of similar income and economic development compete with each other. Countries prohibited by current statutory restrictions from receiving U.S. assistance will not be eligible. Qualifying as a better performer does not guarantee receipt of MCA funds. The MCA Board of Directors, composed of Cabinet-level officials and chaired by the Secretary of State, will make final recommendations to the President.

As already noted, the provision of grants rather than loans will ensure that the MCA program will not add to countries' debt burdens. The resources provided can then be allocated as intended, to development rather than debt service. Aid in the form of loans causes many heavily indebted poor countries to accrue even greater debt, which can hinder their growth. One study of

93 developing countries from 1969 to 1998 found that, for a country with average indebtedness, doubling the debt ratio (either the debt-to-exports ratio or the debt-to-GDP ratio) reduces annual growth of GDP per capita by between 0.5 and 1 percentage point.

Reforming the Multilateral Development Banks

The Administration believes that the World Bank and other multilateral development banks will be more effective in helping countries improve their living standards if, when distributing aid, they place greater emphasis on factors that improve productivity. The Administration's agenda for reform of the MDBs seeks progress toward better measurement, monitoring, and management of development assistance. The Administration also has pushed for an increase in the proportion of MDB assistance to the poorest countries that is delivered in the form of grants rather than loans.

MDBs will be more effective in reducing poverty if they address the basic causes of slow growth, including poor business environments and inadequate education and health care. This means that MDBs should help countries reduce the impediments that constrain the creation of high-productivity jobs in the private sector. To this end, the United States has secured agreement on a change in assistance strategies by the IDA. IDA funds will now include the distribution of resources to private sector development, in addition to the public sector uses that have been its traditional focus. This agreement creates the basis for expanded collaboration between the IDA and the International Finance Corporation, the World Bank Group's private sector finance arm. Such collaboration will help remove the obstacles to private sector-led growth in the world's poorest countries.

The Administration also believes that a major priority for the MDBs should be greater attention to measuring development results. Donor and recipient countries both benefit from quantifying the outcomes of assistance programs and understanding the reasons for success or failure. The recent IDA replenishment agreement calls for a fundamental shift of focus within the MDBs toward measurable results. IDA will also establish a system that tracks specific results in education, health, and private sector development. These innovations will allow donors to link their contributions to IDA to observable outcomes. This approach will help direct scarce donor dollars toward those activities and projects that are demonstrably improving people's lives. Furthermore, the Administration's position is that MDBs should expand similar results-based operational plans into all of its grant and loan programs.

Consistent with the MCA approach, U.S. leadership has resulted in a significant expansion of MDB grants for the world's poorest countries. In July 2001 the President called upon the World Bank and other MDBs to increase the proportion of their assistance to the poorest recipient countries that is provided as grants rather than loans. One year later, the United States finalized an agreement with other international donors on a substantial increase in grants. As a result of this agreement, IDA grant assistance for programs targeting education, HIV/AIDS, health, nutrition, potable water, and sanitation will be increased. U.S. leadership was also crucial in obtaining agreement on an increase in grants for the recently concluded replenishment of the African Development Fund. These agreements significantly advance the Administration's policy objective of helping poor countries make productive investments without saddling them with ever-larger debt burdens.

The Administration recognizes that countries may sometimes face economic crises that can lead to sharp net outflows of capital. Countries will be well served if these crises can be managed effectively. Consequently, in parallel with MDB reform, the Administration believes that clarifying the size of official financing packages from the international financial institutions is essential to increasing predictability in the market, curbing excessive risk taking, and providing the right incentives for countries to pursue good policies. The Administration has worked to create a more orderly and predictable process for restructuring sovereign debt, so that the long-term growth of developing economies is not subverted by short-term crises. In particular, the Administration has proposed the incorporation of collective action clauses into sovereign debt contracts to facilitate a more predictable and transparent resolution of sovereign debt defaults when they do occur.

Conclusion

Economic growth has the potential to improve the lives of millions of people around the globe, both through higher incomes and through improvements in social indicators such as health outcomes. This chapter has laid out three broad principles for promoting growth.

Economic freedom is a critical prerequisite for the harnessing of entrepreneurial energy to improve productivity and increase growth. Macroeconomic stability, including low inflation and small fiscal deficits, helps create an economic environment in which people can plan and invest. Governments should avoid burdensome regulation, distortionary taxes, and nationalization of industries, because all of these lead to inefficiency and slow growth. Openness to international goods, services, and capital brings with it exposure to world best practices and generates the competition that leads domestic firms and workers to enhance their productivity.

Poor institutions, especially those that fail to enforce property rights, promote the rule of law, and discourage corruption, can subvert good economic policy decisions. Entrepreneurs will be less willing to commit resources for the long term if they believe that arbitrary decisions by governments may rob them of the anticipated returns. Workers will be more reluctant to work hard if they believe the fruits of their labor will be seized by corrupt officials or criminals. Ultimately, promoting growth depends on appropriate policies, aimed at both macroeconomic stability and creating a supportive economic environment.

Investment in people, through improvements in both education and health, will support a work force that can fully utilize the opportunities created by sound policies and good institutions. Well-trained workers will be better able to make productive use of the capital available to them, both the existing capital stock and new investment. This will lead to higher productivity and enhanced growth. A healthy work force will be less prone to absenteeism, allowing a higher rate of utilization of capital, and this, too, will improve the country's economic prospects.

The Administration's initiatives—the promotion of openness to the world economy through trade liberalization, and the new approaches to bilateral and multilateral development assistance—are intended to complement developing countries' own efforts to improve their economic performance. TPA will help the United States reach agreements that increase trade and thus foster growth in developing countries. The MCA will provide both financial assistance to the least developed countries and incentives for them to implement pro-growth policies. Reform of the MDBs will complement the MCA initiative by focusing these institutions' funds on pro-growth efforts, especially in the private sector, and assisting the world's least developed countries through grants in aid. Through all these programs, the United States will stimulate worldwide economic development, raising incomes in developing countries and spreading prosperity both at home and abroad.